F. & M. Schaefer Brewing Co. v. Commissioner, 27 T.C. 1121 (1957)

Under the Internal Revenue Code, a company can be granted excess profits tax relief if a change in the character of its business during or before the base period caused its average base period net income to inadequately reflect its normal earnings.

Summary

The F. & M. Schaefer Brewing Co. sought relief from excess profits taxes, arguing that changes in its business operations during and before the base period negatively impacted its average base period net income. The Tax Court found that opening a new plant and company-owned warehouses constituted a change in the business's character. The court determined a 'constructive average base period net income,' considering the impact of these changes, and granted tax relief. The court aimed to determine what the company's earnings would have been if the changes had occurred earlier, thereby providing a fairer assessment of its normal earnings capacity. This decision hinged on establishing that the business changes resulted in an inadequate reflection of the company's normal earnings during the base period, necessitating a reconstruction of the income figures for tax calculation purposes.

Facts

F. & M. Schaefer Brewing Co. (the "Taxpayer") experienced several changes in its business operations during the base period of 1936-1939, and immediately prior to it. These included opening a new plant in Coffeyville, establishing three company-owned and operated warehouses, and modifying its sales and distribution strategies. The Taxpayer argued these changes affected its earnings during the base period and that its average base period net income did not reflect its normal operating capacity. Specifically, the changes included the Coffeyville plant selling more high-profit margin feeds, and increased sales following the opening of a warehouse in St. Joseph. The Taxpayer sought a "constructive average base period net income" under Section 722 of the Internal Revenue Code of 1939.

Procedural History

The Taxpayer initially sought relief under Section 722. After applications, and claims before the Court, the Tax Court considered the Taxpayer's petition. The Tax Court then reviewed the changes in the business, their impact on earnings, and the appropriate level of relief. The Court made findings of fact and entered decisions under Rule 50.

Issue(s)

1. Whether the opening of the new plant and the warehouses constituted a "change in the character" of the Taxpayer's business.
2. Whether the Taxpayer established that its average base period net income was

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an inadequate standard of normal earnings because of these changes.
3. If so, what was the appropriate "constructive average base period net income" to reflect normal earnings?

Holding

1. Yes, because the new plant and warehouses altered the Taxpayer's operations and the products sold, impacting its earning level and the reflection of its normal earnings during the tax period.
2. Yes, because the changes, made during or before the tax period, meant that the average base period net income did not reflect normal operations for the entire period.
3. The Court determined that the Taxpayer established a constructive average base period net income, in excess of its arithmetic average base period net income.

Court's Reasoning

The court applied Section 722 of the Internal Revenue Code of 1939, which allowed for tax relief if a taxpayer's average base period net income was an inadequate measure of normal earnings due to a change in the business's character. The Court found that the opening of the new plant and the company-owned and operated warehouses were indeed a "change in the character" of the business. The court noted that if these changes had occurred earlier, specifically two years prior to when they actually did, the taxpayer's earnings would have been higher. The Court considered evidence regarding sales trends, profitability of different products, and the impact of new facilities, such as the increased sales due to the company warehouse. The court rejected some of the taxpayer's contentions regarding allocation of expenses.

The court noted, "We think petitioner has established that if the changes in character had been made 2 years earlier it would have had at the end of the base period an earning level considerably in excess of its actual level." The court reconstructed income to arrive at a constructive average base period net income, taking into account the impact of the changes and adjusting for any abnormal benefits. The Court reasoned that it was "reasonable to assume that if these two warehouses that were opened in 1939 had been opened 2 years earlier, they would have been as successful as the one at St. Joseph and that some additional income should be reconstructed accordingly."

Practical Implications

This case is important for businesses seeking relief from excess profits taxes where changes in business operations impacted earnings during the relevant tax period. The case clarifies the application of Section 722, demonstrating that changes in operations, like opening new plants and distribution centers, can qualify as changes

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in the character of the business. It provides a framework for demonstrating that a company's average base period net income is an inadequate measure of normal earnings. The court's focus on the impact of the changes and the reconstruction of income levels shows how to present evidence and make arguments. Future cases of this nature need to focus on proving that changes to a business during a certain period, or before, negatively impact revenue calculations. The case highlights the necessity of carefully documenting the nature of the changes, their timing, and their financial effects. The case shows that courts will look to how the business would have performed had the changes occurred earlier.

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